

Is a zero-Covid policy hurting China's economic recovery?

While China's exports are doing well, the government's zero-tolerance policy on Covid-19 plus other factors are having an impact on aggregate demand and supply, posing challenges to its recovery.

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China's slowing economic growth poses challenges for the world's economic recovery.

According to recent data from the National Bureau of Statistics (NBS), China's third-quarter economic growth rate is 4.9 per cent, which is down from the 7.9 per cent growth in the second quarter. In particular, the manufacturing purchasing managers' index (PMI) in October was at 49.2, down from 49.6 in September, indicating that factory activities are shrinking.

Meanwhile, the producer price index (PPI) hit a record high, rising 10.7 per cent year on year in September, reflecting the higher costs industries face in making products. It raises the pressure to pass the higher costs to consumers, which may lead to worldwide inflation.

China has been viewed as one of the engines for global recovery. However, the above data, along with several recent challenges such as a power crunch, the Evergrande Group debt crisis, supply chain bottlenecks and more disruptive pandemic restrictions, could hinder its recovery. Do these challenges pose any market systematic risks? Can China's policies restore economic growth? Should other countries be alarmed by China's economic slowdown?

The answer may be found in taking a closer look at China's aggregate demand and aggregate supply.

AGGREGATE DEMAND HIT BY ZERO-COVID POLICY

Aggregate demand is a measurement of the total amount of demand for all final goods and services produced in an economy. Consumption, investments and net exports are three important factors that determine total demand.

Weak consumption has been a persistent problem in China, slowing the recovery of its economic growth. In 2020, China's per capita consumption spending experienced a real decrease of 4



The coal-powered Datang International Zhangjiakou Power Station in China's Hebei province. The country's factories need more power to meet a surging demand for Chinese goods. But many coal mines have been shut down in recent years due to China's push for a greener electricity supply. PHOTO: AGENCE FRANCE-PRESSE

per cent after deducting price factors.

Despite the rebound in the first three quarters of this year, the August retail data is very disappointing, growing only 2.5 per cent from a year ago, which is well below the 7 per cent growth expectation. This is a result of China's "zero tolerance" policy for Covid-19 cases and local lockdowns imposed in order to control the highly contagious Delta variant. The policies disrupted retail sales from returning to pre-Covid-19 levels.

Before the spread of the Delta variant, China successfully brought the number of infections to zero. Retail, tourism and manufacturing industries quickly resumed to pre-Covid-19 levels. But this was disrupted by the highly contagious Delta variant. Since July, new infections have appeared in several cities, which then halted all trains and flights, closed the local highways, initiated mass testing and imposed lockdowns.

There is no sign that these measures will be eased in the near term. The intermittent Covid-19 outbreaks, together with the zero-Covid policy, pose an economic threat and create uncertainty.

Residents having to stay at home decreases the demand for some consumer goods. Small businesses, such as retail stores, restaurants and travelling agencies, incur higher operating costs due to the uncertainty. Some workers would even have to face lower incomes or even unemployment. This would further dampen domestic

consumption.

China's recent property crackdown policies have cast another shadow over the economy. The authorities decided to cut its reliance on real estate, a key driver of GDP growth. Housing activity accounts for about 29 per cent of China's GDP, which is far above the 10-20 per cent seen in most developed nations, according to *The Guardian*.

Frantic real estate developers have loaded up on debt, bringing a crisis to the whole economy. Most prominently, the Evergrande Group, one of the largest property developers in China, racked up more than US\$300 billion (S\$405 billion) in debt because of the crackdown on property developers' reckless borrowing and a sluggish property market. Whether the authorities will step in with a rescue is uncertain.

Panic among investors and home buyers will affect property sentiment. People with shrinking assets are likely to reduce their consumption and investment, affecting the aggregate demand even more.

Fortunately, China's export sector has outperformed expectations since the effective containment of the virus early last year. The outbreak of Covid-19 in developing countries, such as India, Thailand and Vietnam, has fuelled global demand for China-made products. China's exports figures in September were unexpectedly robust, rising 28.1 per cent year on year from a year ago. It reflects solid global demand for Chinese products.

AGGREGATE SUPPLY FALLS SHORT

Will there always be enough supply to meet global demand for Chinese products? To have sufficient supply, producers must have sufficient raw material and labour at reasonable prices. Unfortunately, China is struggling with severe energy and labour shortages.

Recently some local authorities in China announced plans for power cuts in the coming months. Factories need more power to meet a surging demand for Chinese goods. But many coal mines have been shut down in recent years due to China's push for a greener electricity supply. The reduction of coal mines and a higher demand for electricity have naturally pushed up coal prices.

For electricity providers, production costs have gone up. But they are not able to increase electricity prices accordingly because of government controls. This has led some electricity providers to reduce production, causing a power shortage.

The power shortages have affected as much as 44 per cent of the country's industrial activity, according to estimates by Goldman Sachs. Many factories would have to either cut production or pass on the higher cost of production to consumers. That would lead to inflation both domestically and globally.

At the same time, Chinese factories are facing a labour shortage. The younger generation disdain factory work, as they perceive it to be dull and

back-breaking. Even though many factory owners have upped their salaries and improved working conditions, it is still hard to find workers. What's more, China's working age population (those between 15 and 59 years old) is shrinking. It was down from 70 per cent of the total population in 2010 to 63 per cent last year, according to a *Wall Street Journal* report.

Wages have been rising but jobs are still unfilled. Many factories have turned down overseas orders and scaled down their production. This capacity limitation is undoubtedly slowing down economic growth.

GOVERNMENT POLICIES

China is restructuring its economy, shifting the manufacturing sector to higher value-add areas, and reducing high debt levels to avoid a debt crisis. It will definitely experience pain in the short term, with the transition leading to a lower-than-expected economic growth.

Currently, Chinese regulators are making every effort to deal with the default of property developers and trying to reduce systematic risks. If the debt crisis brought by the Evergrande Group cannot be resolved effectively, it will affect the GDP growth in the fourth quarter, as well as affect overseas financial markets negatively.

Last month, China loosened its pricing control on electricity, allowing energy firms to set prices in the open market. While this would push up the prices of electricity, it would also incentivise firms to supply more.

Earlier this year, China announced that it would allow couples to have up to three children. Subsequently, the government decided to regulate the private tutoring industry to alleviate financial burdens of young couples, with the hope that it would encourage them to have more children. The policy may not have a positive impact on economic growth in the short term. But in the long run, with more people responding to the policy, couples may have more children and this could help to fill the labour gap.

China views boosting domestic consumption as a priority in its 14th Five-Year Plan from 2021 to 2025. To achieve this goal, many provinces and municipalities are adjusting their minimum wages to increase household income.

However, due to the recent rise in food prices, rising wages may not be enough to outpace inflation.

Another factor affecting economic prospects is military tensions between the mainland and Taiwan. It has been described as being "at its worst in 40 years". At the moment, the odds of war happening between the mainland and Taiwan in the near future are still very low. But if such a black swan event happens, it will have an unpredictable impact on China's economic growth.

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